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¶1. (SBU) SUMMARY. President Calderon has announced three sets of economic stimulus packages to help offset the impact of the global financial and economic crisis and stimulate the economy. The Mexican banking sector remains solid with an adequate capitalization rate. However, the deepening of the global crisis and the lack of positive reactions to the U.S. stimulus package have worsened Mexico's economic outlook for 2009. Most analysts expect a GDP contraction of more than 3%, given the country's close link to the U.S. economy. While the government is implementing measures to protect its most vulnerable sectors, it has also called the international community to prevent protectionism and keep trade flowing freely. End Summary.

Stimulus:

¶2. The Mexican government has announced three stimulus packages over the past 12 months: "Program to Support to the Economy" announced on March 3, 2008; "Program to Stimulate Growth and Employment" announced on October 8, 2008; and "The National Accord in Favor of Families, the Economy and Employment", announced on January 7, 2009.

--The first stimulus package included a set of measures worth approximately $ 1.7 billion and involved tax incentives, such as a 3% reduction in the provisional payments of income (IRS) and single corporate tax (IETU) as well as other tax incentives for small businesses. It also included government support to stimulate employment, such as subsidies in social security fees paid by employers and peak-hour electricity rates reductions for the productive sector and more budgetary resources for development banks.

--The second program focused on increasing spending in infrastructure and facilitating the timely development of infrastructure projects, which include the construction of a refinery, toll roads, school, water treatment plants, railway tracks, etc; support to small and medium-sized via financing from development banks, and the elimination and streamlining of import duties. This package ws worth approximately $10 billion.

--The third package targets job creation, avoiding layoffs, pension protection, lowering electricity rates, freezing gasoline and gas prices and boosting investment in infrastructure. This package involves resources from development banks and trust funds valued at approximately 1% of GDP.

These programs will not increase the government's fiscal deficit more than the 1.8% of GDP approved by the Mexican Congress for 2009. The government will be financed through oil hedging, tax

collection, stabilization funds and if necessary spending cuts in other areas.

Financial Sector:

¶2. The Mexican banking sector is relatively solid, having not acquired toxic assets, and therefore, not requiring the same injection of capital as banks in other parts of the world. The banks' capitalization level is currently adequate -around 14%- and their key concern to date has been a hike in the rate of credit cards defaults, which currently stands at around 10%. Most of the banks have reacted by decreasing the number of credit cards issued to private citizens and are being more careful on their risk analysis. Banks with the largest number of defaults have implemented programs to help clients renegotiate their debts. As a result of the growth in unemployment and the expected growth in non-performing loans, banks might be forced to increase their capital reserves to the detriment of their profits.

¶3. In October 2008, the government reported significant losses from companies involved in risky derivative ventures. The firms included large enterprises such as Comercial Mexicana, Cemex, Vitro, Alfa and Gruma. The Mexican government announced that it will require Mexican companies whose shares are traded on the Mexican stock exchange to adopt International Financial Reporting Standards (IFRS) to provide greater transparency and clarity for foreign and local investors in Mexican publicly-traded companies.

¶4. Mexican financial authorities have called both for stricter supervision of corporate finances and the elimination of existing legal loopholes. The Finance Secretariat has been working for some time now on legislation to simplify existing bankruptcy procedures, as part of the lessons learned from the financial crisis in 1995, which include early alerts and a deeper risk analysis for granting loans. A group of Senators and the Bank of Mexico governor have publicly criticized banks, especially foreign ones, for charging higher interest rates than in their countries of origin. The Congress intends to pass a bill to put a cap on interest rates to allegedly help stimulate credit.

¶5. The U.S. government's announcement of the conversion of its preferred stocks in Citi in common equity generated controversy in Mexico about the future of Banamex, which Citi acquired in 2001. Some observers have said that Mexican financial laws prohibit a

foreign government from having a stake in Mexican banks. The Senate considered a bill that could eventually have forced Citi to return Banamex to Mexican hands. Discussion of the bill was postponed until the government, through the Finance Secretariat, announces this week its interpretation of what is allowed under Mexican laws and international agreements.

Real economy:

¶6. The deepening of the global crisis and the lack of positive reactions to the U.S. stimulus package have worsened Mexico's economic outlook for 2009. The Bank of Mexico now projects a GDP decline of between -0.8 and
-1.8%, but most analysts are expecting a contraction of more than 3%, given the country's close link to the U.S. economy. Exports, industrial output, consumption, remittances and foreign direct investment have all suffered the effects of the crisis. During the fourth quarter of 2008, non-oil exports to the U.S. fell 9.7%. Within them, automobile exports to the U.S. - Mexico's largest manufacturing exporter - fell 11.1%. In December 2008, industrial output registered its eighth consecutive decline slumping 6.7%. Both, the manufacturing and construction sectors plunged by 6.6% and 7.1%, respectively. Foreign direct investment and remittances, the second and third most important sources of foreign exchange inflows fell 31% and 3.6% in annual terms in 2008. Expected further declines in foreign currency inflows in 2009 will increase the current deficit from 1.4% of GDP in 2008 to between 2.6 and 3% of GDP.

¶7. The most vulnerable sectors of the economy are the automobile, auto parts and maquila sectors. In January, production and exports from the automobile industry fell 51% and 57%, respectively. In an attempt to prevent permanent closures protect employment in these sectors - about 500,000 jobs- the government implemented a $ 135 million program to economically support manufacturing companies which have been forced by economic conditions to call for technical stoppages. About 500 companies have registered to receive support, which consists of paying part of the companies' payroll with government budget resources.

¶8. While the government is implementing measures to protect its most vulnerable sectors, it has also called the international community to prevent protectionism and keep trade flowing freely. As a token of its commitment to free trade, Mexico eliminated tariffs on imports from non-FTA partner countries in December. At the G20 meeting on November 15, 2008 President Calderon and other leaders pledged to refrain from raising new barriers to trade. Calderon is not only adhering to this commitment; he is reducing barriers to trade in the hopes of spurring economic growth and opportunities to offset a deeper economic downturn.

¶9. The announcement of the "Buy American" provision first raised concerns among the government and possible affected industries, such as Mexican steel and the manufacturing sector. The latest Mexican government's statement about the provision is that it has been watered down to prevent violating international agreements. Calderon has expressed concern that a potential review of NAFTA might create uncertainty especially in those sectors where the economy has shown substantial growth in recent years.

Social/Labor Impact:

¶10. The official jobless rate -which masks informal employment, underemployment, and discouraged workers who are not actively

seeking employment - reached a record of 5% in January. Some analysts believe that unemployment could well reach 10 or 12%. The two traditional escape valves, migration to the U.S. and employment in the informal sectors are becoming insufficient to absorb the

number of unemployed. The government has announced a set of measures to address increased unemployment. These measures include: temporary unemployment insurance that includes training programs and healthcare services; expansion of the current temporary public works employment program 40% over what was initially planned to cover 250,000 Mexicans; allowing unemployed workers to take money out of their pension funds before retirement without penalty; expansion of social and health coverage for people who lose their jobs.

¶11. Having failed to deliver as the employment president, Calderon and his PAN party face a hard challenge in 2009 congressional and governor races. Deteriorating security and economic conditions will erode Calderon's PAN chances of winning more congressional seats in July and could eventually open the door to more populist challengers. Moreover, the failure to absorb the current and future labor force might eventually increase insecurity and poverty levels. Jobless Mexicans may find it more difficult to resist working for criminal organizations.

Dimension of the Crisis:

¶12. Although the Mexican government has frequently praised the country's macroeconomic stability and solid banking sector, it has finally acknowledged that Mexico is feeling the effects of a global economic "tsunami". It is unlikely that the Bank of Mexico will meet its inflation target due to the pressure exercised by the peso depreciation. The higher inflation expectations have prevented the central bank from relaxing its monetary policy as fast as the government would like to see.

¶13. The economic slowdown will significantly reduce the government's tax revenues. The expected decline in oil production and prices motivated the government to hedge its oil revenues for 2009 at $ 70 per barrel for about 75% of its exports. This wise decision plus the increase in the fiscal deficit from a balanced budget to 1.8% of GDP and financing expected to be obtained from the Inter-American Development Bank and the World Bank will help Mexico weather the economic crisis in 2009 and part of 2010. Should the recession last beyond 2009, the government still has resources in its stabilization funds that could be used to prevent cuts in public spending or an increase in the fiscal deficit. Government sources have told Embassy officers that they remain committed to maintaining public deficit under control. Thus, in the medium term, Mexico will have to pass bills to increase its tax collection and non-oil revenues.

Financial markets and liquidity:

¶14. The Mexican government has taken a number of measures to support liquidity in debt markets. Last year, the Bank of Mexico announced a measure to allow commercial banks to use their required reserves

as collateral for short-term funding through guaranteed loans. Banks can also access short-term funding via repurchase agreements with the Bank of Mexico in exchange for government and corporate debt instruments. The Economic Secretariat has set up a guarantee fund of about $ 167 million to improve non-bank financial institutions' (sofoles and sofomes) access to liquidity.

¶15. The Finance Secretariat, through the government's development banks Nafin and Bancomext, announced a guarantee program to help companies roll over short-term debt or commercial paper. Last year, there were liquidity shortfalls in Mexico's mortgage market, but the housing development bank, Sociedad Hipotecaria Federal (SHF) offered approximately $ 2.7 billion to support debt issuances, special credit lines and bridge loans. SHF also negotiated a $2.5-billion loan with the Inter-American Development Bank.

¶16. The Bank of Mexico and the Finance Secretariat implemented in 2008 a series of measures aimed at alleviating pressures in the local bond market. The initiatives include a reduction of 10, 20 and 30-year government bond issuances in favor of treasury bills; credit lines of up to $5 billion to the government from multilateral lenders; a reduction of the size of the weekly auction of debt

securities issued by deposit insurance agency IPAB; and the establishment of a program that will enable the central bank to repurchase IPAB securities.

¶17. The National Infrastructure Plan is seen by the Calderon administration as the largest stimulus economic and employment tool. However, the existing credit crunch has prevented the government from bidding large infrastructure programs such as the mega port in Punta Colonet and toll road packages. The real annual growth of direct financing to the private sector by commercial banks has decreased from 15.4% in July 2008 to 5.4% in January 2009. The growth of direct lending for businesses fell from 20.8% to 19.4% during the same period, but the sector that has been hit the hardest has been consumer credit. Direct lending by commercial banks to consumers declined 33% in January 2009.

Foreign exchange rate and Bank of Mexico's response:
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¶18. The peso depreciated 55% from its highest level in August 2008 - 9.3 to 15.35 pesos to the dollar - as of March 10. Investors' quest for liquidity and safety has led them to reduce their exposure to emerging markets. Moreover, speculative bets on the exchange rate and on the central bank's dollar auctions have also negatively impacted the peso. In an effort to moderate volatility, the Bank of Mexico has intervened in the foreign exchange market via daily dollar auctions and extraordinary direct offerings of dollars. The Bank of Mexico has used about $19 billion of its $85 billion international reserves to ease the peso volatility. The currency depreciation has helped exporters, public finances and remittance recipients with the peso conversion, but will also have an undesired impact on the inflation.

Role of the G20 and Mexico's goals:

¶19. President Calderon and the GOM have made few public comments about Mexico's goal for the G20. During President Sarkozy's March 8-10 trip to Mexico, he and President Calderon discussed the G-20 and the possibility of finding common goals in their positions. Calderon gave an interview to AFP in which he said that Germany and France are strong leaders in the search of measures to mitigate the crisis. He added that it is urgent to restore the financial and banking sector in particular those of the U.S. He stressed that it was vital to restructure multilateral financial institutions. Calderon expects that from the London summit, members will come up with quick and concrete solution. Otherwise it would be difficult to see the end of the global crisis.

Note: All figures in this cable are in US dollars. Embassy Mexico POC on the G-20 are Economic Counselor Adam Shub (shubam@state.gov) and Deputy Economic Counselor Sigrid Emrich (emrichs@state.gov)